Factors Impacting the Municipal Market as We Approach 2014

With economic data strengthening as 2013 draws to a close, the market's focus has moved to the timing and magnitude of a Fed response. We expect the trading range in the intermediate to longer end of the yield curve to rise somewhat (from the 2.50%-3.20% range to a 2.80%-3.50% range on the US Treasury 10Yr), and that higher rates and a steeper curve will present an opportunity to reposition portfolios in the new rate environment. Supply will be challenged to satisfy demand, particularly when fund flows stabilize and the market at some point sees net inflows. Below are the major factors we see impacting the municipal market as we approach 2014.

The Taper

- Markets will react in QI to the imminence of the Taper (with a probable announcement at the late January FOMC meeting), with rates potentially rising as the fear of the reduction in asset purchases and the recent memory of the July – September experience drive asset decisions.
- ***The Taper is not new news, but should cause an overreaction early in the process, likely resulting in a correction with rates stabilizing in QII.***

Fund Flows and Impact on Relative Value

- The Municipal Market has absorbed over $53 billion in mutual fund outflows in 2013 YTD, with $10.6 billion in Intermediate funds and $42.4 billion in Long Term funds. While this has put pressure on the asset class at various points throughout the year, the Municipal asset class is closing the year at some of the lowest ratios to Treasuries we have seen all year, particularly in the short/intermediate area of the yield curve:

MUNICIPAL TO TREASURY RATIOS

	12/31/2012	11/30/2013
3Yr Municipal as a % of Treasuries	125%	92%
5Yr Municipal as a % of Treasuries	113%	85%
10Yr Municipal as a % of Treasuries	98%	97%

Source: MMD & Bloomberg

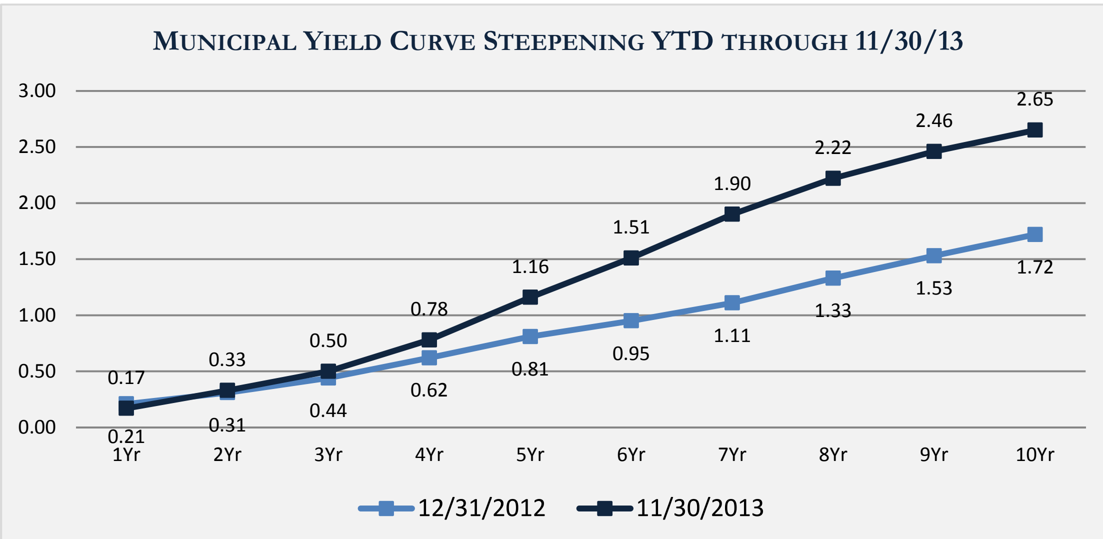
- ***These outflows should begin to subside at some point in the first half of 2014 and the pressure this has placed at times in the secondary market will be relieved. In a higher rate scenario, there is the probability that capital will begin to flow back into the asset class, increasing demand quickly.***

Net Negative Issuance

- Lower issuance levels in 2013, particularly in the second half of the year, have been a big contributor to the relative value of the asset class and its outperformance. Issuers' cost savings to refund outstanding debt has diminished greatly and in some cases has disappeared, as rates have moved higher in 2013. As of November 30th, year to date total Municipal issuance has been $301 billion versus $353 billion for the same period in 2012. Expectations for 2013 issuance had been in the $380 billion range. 2013 issuance levels have not been sufficient to offset the coupons, calls, and maturities this year, leaving the market with net negative new issuance.
- ***Given the outlook for 2014 issuance (in the $300 billion range), it is likely that there will be another year of net negative issuance, which could continue to fuel the supply and demand imbalance that we are seeing at the close of 2013. The size of this asset class is shrinking.***

Yield Curve Exposure

- The curve has steepened dramatically in 2013 as the 2Yr–10Yr Municipal curve steepened from 141bps on 12/31/2012 to 232bps on 11/30/2013. This increase of over 100bps on the year has added to the benefit of the rolldown effect as bonds age and "roll down" the yield curve. Particularly in the 5-8Yr part of the curve, the pick-up has become dramatic.
- ***Given the Fed's intention to maintain very low short-term rates well into 2015, the curve will remain steep in 2014 and will continue to add value in the intermediate area of the curve.***



AAA Rated MMD Discount Curve
Source: MMD & Appleton Partners, Inc

Taxes Are Not Going Lower Next Year

- The hidden tax increases in 2013 that have come with the Sequester and the Affordable Care Act will likely not be repealed in the next year, and could in fact be pressured higher as the need to decrease deficits at all levels of government returns to front and center. The debate will begin in January 2014 when the debt ceiling and budget debate hits another short-term deadline.
- ***The tax exemption on Municipal income should become more valuable as we move through 2014.***

Headline Risk Will Continue to Plague the Markets in 2014 Even as Underlying Credit Trends Improve

- The news on names like Puerto Rico, Detroit, and Illinois should continue to capture headlines in 2014, as the issues plaguing these entities still need to be resolved. The pressure on pension reform at all levels will be key, and the outcome of the Detroit bankruptcy as it moves through the court system will be critical to the future of marginal issuers in the market.
- ***Credit research at the security level becomes more critical in identifying value and in avoiding potential pitfalls in Municipal bonds. While other fixed income asset classes may see lower quality add value in 2014, lower quality in the Municipal spectrum will likely be a drag on overall performance due to headline risk with specific large issuers. That said, overall revenue has been increasing, with states experiencing 14 consecutive quarters of revenue growth. Despite this trend, we continue to see divergence from the ratings agencies, with Moody's tending to downgrade credits while S&P has been looking more positively at Revenue Bonds. Overall, we continue to see muni credit stabilizing, with pockets of stress in a few limited regions of the country. Of course, these pockets of stress tend to grab those headlines.***

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